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## MORTGAGES—PROBLEMS IN POSSESSION, RENTS, AND MORTGAGEE LIABILITY

ROBERT KRATOVIL

THE HISTORY of mortgage law is the history of hundreds of years of ceaseless struggle for advantage between borrowers and lenders, and the lawbooks reflect the constantly shifting fortunes of this war. Occasionally the battle has gone in favor of the lenders. More recently the battle has usually gone in favor of the borrowers, and many laws favorable to the borrowers have been passed. To understand how the modern mortgage developed out of these centuries of struggle is to take a long step forward toward understanding modern mortgage law.

Much of our mortgage law comes to us from England. In that country, mortgage arrangements of various kinds existed even in the Anglo-Saxon times before the conquest of England by William the Conqueror in 1066 A.D. However, it will suffice for our purposes to begin with the mortgage of the 14th century. This document was a simple deed of the land, running from the borrower, (mortgagor) to the lender (mortgagee). All the ceremonies needed for a full transfer of ownership took place when the mortgage was made. The mortgagee became the owner of the land, just as if a sale had taken place. However, this ownership was subject to two qualifications:

1. The mortgagee, as owner, could and often did oust the mortgagor and take immediate possession of the property and collect the rents. However, it was necessary that the rents so collected be ap-

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plied on the mortgage debt. For this reason, the mortgagee often permitted the mortgagor to remain in possession.

2. The mortgage described the debt it secured and stated a date of payment known as the law day. The mortgage gave the mortgagor the right to pay the debt on the law day. If he did so, the mortgage provided that it was thereby to become void. This provision was known as the defeasance clause, for payment of the debt on the law day defeated the mortgage and put ownership back in the mortgagor.

In early times, the courts enforced the mortgage as it was written. Foreclosure proceedings were not necessary and did not even exist. Failure to pay the mortgage debt when due, termed a default, extinguished all the mortgagor's interest in the land.

For many years no one dreamed of questioning this scheme of things. Then, slowly at first, and later in greater numbers, borrowers who had lost their property through default began to seek the assistance of the king. A typical petition addressed to the king by such a borrower would set forth the borrowing of the money, the making of the mortgage, the default in payment, and the resulting loss of the land. The petition would continue with the statement that the borrower now had funds and offered to pay the mortgage debt in full, with interest. The petition would then ask or pray that the king order the mortgagee, who now owned the land, to accept the proffered money and to convey the land back to the borrower. The king had little time or inclination to tend to these petitions personally, and so he habitually referred them to a high official, the Lord Chancellor. Since the king was the fountain of all justice, it was the Chancellor's duty to dispose of these petitions justly and equitably, according to good conscience, and this he did. In cases of hardship or accident, for example, where the mortgagor had been robbed while on his way to pay the debt, the Chancellor would order the mortgagee to accept payment of the debt from the borrower and to convey the land back to the borrower. A mortgagee who refused to do as he was told was sent to jail. In time, by about the year 1625, what had begun as a matter of grace on the part of the king had developed into the purest routine. Borrowers filed their petitions directly with the Chancellor, who was now functioning as the judge of a court, instead of with the king, and with routine regularity his order issued, commanding the mortgagee to convey. Thus a new and very important right was born, the right of the mortgagor to pay his debt even after default, and in this manner to recover his property. This right came to be known as

the equitable right of redemption, or the equity of redemption. Later the courts held that the mortgagor could sell this equitable right of redemption; that he could dispose of it by his will; and that if he died leaving no will, the right could be exercised by his heirs. As a result of these developments, the mortgagor, even after default, retained very important rights in the land. Technically the mortgagee became full owner of the land upon default, but practically the mortgagor could now be regarded as the owner even after default, since he could re-acquire ownership by making redemption.

The mortgagees reacted to the development of the equitable right of redemption by inserting in their mortgages clauses reciting that the mortgagor waived and surrendered all his equitable rights of redemption. The courts, however, nipped this idea in the bud by holding that all such clauses were void, since a necessitous borrower will sign anything, and it is up to the courts to protect him. This rule thrived and flourished and exists in full vigor today. Any provision in the mortgage purporting to terminate the mortgagor's ownership in case of his failure to make his payments when due is against public policy and is absolutely void. "Once a mortgage, always a mortgage." It cannot be converted into an outright deed by the mere default of the mortgagor. And no matter how the mortgagee seeks to disguise an attempted waiver of the equitable right of redemption, the courts will strike it down. For example, in one case, at the time the mortgage was made, the mortgagor signed a deed conveying the property to the mortgagee as grantee, and delivered the deed to a third person in escrow with directions to deliver the deed to the mortgagee in case of default in the mortgage payments. This deed and escrow were held invalid, as an attempted waiver of the equitable right of redemption.<sup>1</sup>

The efforts of the courts to rescue the mortgagor in turn placed the mortgagee at a disadvantage. The mortgagee, it is true, became the owner of the land when the mortgagor defaulted, but he could not be certain he would remain the owner, for the mortgagor might choose to redeem. To remedy this situation, a new practice sprang up. Immediately upon default in payment of the mortgage debt the mortgagee would file a petition in court, and the judge would enter an order, called a decree, allowing the mortgagor additional time to pay the debt. If he failed to pay within this time, usually six months or a year,

<sup>1</sup> *Plummer v. Ilse*, 41 Wash. 5, 82 Pac. 1009 (1905). *Accord*, *Hamud v. Hawthorne*, 52 Cal.2d 78, 338 P.2d 387 (1959).

the decree provided that his equitable right of redemption was thereby barred and foreclosed. Thereafter he could not redeem his property. Thus developed the foreclosure suit, a suit to bar or terminate the equitable right of redemption.<sup>2</sup>

The method of foreclosure just described is known today as strict foreclosure. It is still used in Connecticut and Vermont. The decree of foreclosure does not order a sale of the premises, but merely allows the mortgagor a specified period to make redemption, that is, to pay the mortgage debt, and further provides that if redemption is not made within such period, the mortgagor and all persons claiming under him shall be barred and foreclosed of all their right and equity of redemption. At the expiration of the time allowed for redemption, the mortgagee becomes the full owner of the property, if redemption has not been made.

The next development was foreclosure through public sale. The idea emerged that in mortgage foreclosures, justice would best be served by offering the land for sale at public auction, for if at such sale the property sold for more than the mortgage debt, the mortgagee would be paid his debt in full and the surplus funds would be salvaged for the mortgagor. This method of foreclosure by sale is the most common method of foreclosure in America today. This development constituted another major victory for the mortgagor. More important still, it led to another and even greater victory for the borrowers. As the practice of foreclosure by sale grew more common, the view began to emerge that the mortgage, despite its superficial similarity to a deed, was really not a deed of conveyance but only a lien on the land—that is, merely a means of bringing about a sale to raise money for the payment of the mortgage debt.

The relatively recent view, that the mortgage is not really a conveyance of land but only a lien, has reached its fullest development in the agricultural and western states although some eastern states follow this view. These states are called *lien theory* states. Certain states, called *title theory* states, still take the older view that a mortgage gives the mortgagee some sort of legal title to the land. Some states take a position midway between these two views. These are called *intermediate* states.

The difference in viewpoint between title theory and lien theory states is of greatest importance with respect to the mortgagee's right

<sup>2</sup> KRATOVIL, REAL ESTATE LAW 229 (3rd ed. 1958).

to the possession and rents of the mortgaged property. To illustrate the significance of this statement let us list, in chronological order, some important dates in a mortgage situation: (1) The date the mortgage is signed by the mortgagor. (2) The date when the mortgagor first defaults. (3) The date when the mortgagee files his foreclosure suit. (4) The date of the foreclosure sale. (5) The date when the statutory redemption period (hereinafter discussed) expires and the mortgagee or other purchaser at the foreclosure sale receives the deed under which he becomes the owner of the mortgaged property.

Let us first make our broad generalizations and thereafter list the particular points of difference that exist. In general, the title states regard the mortgage as retaining some of its early character, that is, they view it as a sort of conveyance of the land, so that *immediately on the signing of the mortgage*, the mortgagee has the right to take possession of the property and collect the rents thereof. On the other hand, the lien states regard the mortgage as merely creating *the right to acquire the land through foreclosure of the mortgage*, so that the mortgagor remains the full owner of the land with the right to possession and rents until the statutory redemption period has expired and the foreclosure deed has issued. In other words, at its most extreme, this difference in point of view represents to the mortgagee the difference between dates one and five in the list, so far as the right to possession and rents is concerned. *In title states, therefore, rents are an important part of the mortgagee's security. In lien states, rents are not part of the mortgagee's security.*<sup>3</sup> Now let us analyze the situation in somewhat greater detail, from the point of view just expressed:

1. In a number of title theory states (Alabama, Maryland and Tennessee, for example) the mortgagee immediately upon execution of the mortgage has the right to take possession and collect the rents of the mortgaged property.<sup>4</sup> This right exists even though the mortgage is silent on this point. There are two exceptions: (1) In recent times laws have been passed in some title states giving the mortgagor the right of possession until default occurs. In effect, these laws convert such states into intermediate states. (2) Many mortgage forms

<sup>3</sup> Grether v. Nick, 193 Wis. 503, 213 N.W. 304 (1927).

<sup>4</sup> Darling Shop v. Nelson Realty Co., 262 Ala. 495, 79 So.2d 793 (1955); Wethered v. Alban Tractor Co., 224 Md. 408, 168 A.2d 358 (1961); 1 AMERICAN LAW OF PROPERTY, § 3.59 (Casner ed. 1952).

used in title states give the mortgagor the right of possession until default.

2. In intermediate states (Illinois, North Carolina, New Jersey and Ohio, for example) the mortgagor has the right of possession until his first default, but after default the mortgagee has the right to take possession. In other respects these states follow title theory.

3. In lien theory states, in the absence of a provision in the mortgage to the contrary, the mortgagor is entitled to possession and rents at least until the foreclosure sale.

4. In some lien states the mortgagor may, either by express provision in the mortgage or by a separate assignment of rents signed at the time the mortgage is signed, give the mortgagee the right to take possession and collect rents as soon as a default occurs, and such provisions are valid.<sup>5</sup>

5. In other lien states provisions such as those described in paragraph four above are considered void as against public policy.<sup>6</sup>

6. In all states, if the mortgagor, *after defaulting in his mortgage payments*, voluntarily turns over possession to the mortgagee, the mortgagee has the legal right to remain in possession. Notice that in paragraph five it is the clause *in the mortgage* binding the mortgagor to give up possession at some future time when default occurs that is held void. The same agreement made after default is valid. The mortgagee is then called a *mortgagee in possession*.

7. Whenever a mortgagee takes possession before he has acquired ownership of the property by foreclosure, the rents he collects must be applied in reduction of the mortgage debt. A mortgagee *does not* become the owner of the property by taking possession. Foreclosure is necessary today in all states for the mortgagee to acquire ownership of the land.

8. Whenever a mortgagee has the right to possession, if he fails to exercise that right and allows the mortgagor to remain in possession collecting rents, it is the universal rule that the rents so collected belong to the mortgagor.

<sup>5</sup> Dick & Reuteman Co. v. Jem Realty Co., 225 Wis. 428, 274 N.W. 416 (1937); Penn Mutual Life Ins. Co. v. Katz, 139 Neb. 501, 297 N.W. 899 (1941); Hulseman v. Dirks Land Co., 63 S.D. 404, 259 N.W. 679 (1935); Kinnison v. Guaranty Liquidating Corp., 18 Cal.2d 256, 115 P.2d 450 (1941).

<sup>6</sup> State ex rel. Gwinn v. Superior Court, 170 Wash. 463, 16 P.2d 831 (1932); Rives v. Mincks Hotel Co., 167 Okla. 500, 30 P.2d 911 (1934); Mutual Ben. Life Ins. Co. v. Canby Inv. Co., 190 Minn. 144, 251 N.W. 129 (1933); Hart v. Bingman, 171 Okla. 429, 43 P.2d 447 (1935).

## PRACTICAL ASPECTS OF THE PROBLEM

A mortgage lender seeks a regular return on a safe investment and does not wish to assume the responsibilities of management. A lender is most unlikely to make a loan that will require him to go into immediate possession of the land, and this right is therefore seldom exercised. On the mortgagor's default, however, it is imperative that prompt action be taken to seize the rents so that they will not be diverted to the mortgagor's own personal use. An eviction suit to enforce the mortgagee's right to possession is often a long, drawn out affair, especially when the mortgagor is interposing all the legal obstacles available to him. However, if the mortgagee files a foreclosure suit, he can often have a receiver appointed in a matter of days, and this is the course usually preferred. It has other advantages. A mortgagee in possession must credit on the mortgage debt not only all the net rents received, but also all rents that he might have received by the exercise of reasonable diligence.

*Example:* A mortgagee took possession after default and ousted the mortgagor's tenant, who was paying thirty-five dollars per month rent. The mortgagee claimed at the time that he had been offered one hundred dollars per month rent. However, the mortgagee himself occupied the premises. The court held that the mortgagee must credit one hundred dollars per month on the mortgage debt.<sup>7</sup>

A receiver's leases are approved by the court, and he assumes no such responsibility. Again, as will hereafter appear, entry by the mortgagee may automatically terminate leases executed by the mortgagor, and if these leases are favorable to the landlord, such a course is to be avoided, if possible. Appointment of a receiver will ordinarily not have such a result.<sup>8</sup> Also, though there is some question, as has been pointed out, as to the right of a mortgagee to retain possession during the redemption period, courts will often allow a receiver to collect the rents during this period, if the foreclosure sale is for less than the mortgage debt.<sup>9</sup>

However, the mortgagee's right to possession is of value to the mortgagee in overthrowing prepaid leases and other devices employed by a mortgagor who is on the brink of default, which is dis-

<sup>7</sup> Merrion v. O'Donnell, 302 Ill. App. 467, 24 N.E.2d 264 (1939).

<sup>8</sup> First Nat'l Bank v. Gordon, 287 Ill. App. 83, 4 N.E.2d 504 (1936).

<sup>9</sup> Haas v. Chicago Bldg. Soc., 89 Ill. 498 (1878).



cussed more fully hereafter. Also, when the mortgagee forecloses, but because of some defect in the foreclosure he fails to acquire good title, the purchaser at the foreclosure sale, who is usually the mortgagee, on obtaining his deed and taking possession, is regarded as a mortgagee in possession. He has the right to retain this possession until the mortgage debt is paid, even though the debt has, in the meantime, become outlawed by lapse of time, so that it would be impossible for the mortgagee to file a new foreclosure suit.<sup>10</sup>

Appointment of a receiver has distinct advantages in many lien states. In most lien states, even though the receiver has been appointed only to preserve the property from destruction, the courts will apply in reduction of the mortgage debt the rents collected by the receiver, despite the absence of an assignment of rents,<sup>11</sup> a truly astounding result. However, in other lien states the courts will not allow the receiver to apply rents to payment of the mortgage.<sup>12</sup>

Where the mortgaged property is occupied by the mortgagor as his home, courts are reluctant to order him to pay rent to a receiver, especially in lien states.<sup>13</sup>

Courts differ as to the grounds for appointment of a receiver. Some say it is enough that the property is inadequate security for the mortgage debt. Other courts require a showing that the security is inadequate and that the mortgagor is insolvent. Still others appoint a receiver only when the property is in danger of destruction.<sup>14</sup>

#### LEASES PRIOR TO MORTGAGE

A lease that antedates a mortgage, if duly recorded, is prior and superior to the mortgage. In most states this would also be the case even if the lease were not recorded, for normally the lessee is in possession and in most states possession gives all the world notice of the tenant's rights. With respect to these prior leases the following points should be kept in mind:

1. Such a lease, since it is prior and superior to the mortgage, cannot be extinguished by foreclosure of the mortgage.

<sup>10</sup> *Stouffer v. Harlan*, 68 Kan. 135, 74 Pac. 610 (1903); *Pettit v. Louis*, 88 Neb. 496, 129 N.W. 1005 (1911).

<sup>11</sup> *Grether v. Nick*, 193 Wis. 503, 215 N.W. 571 (1927).

<sup>12</sup> *Windom Nat'l Bank v. Reno*, 172 Minn. 193, 214 N.W. 886 (1927); *Desiderio v. Iadonisi*, 115 Conn. 652, 163 Atl. 254 (1932).

<sup>13</sup> *Holmes v. Gravenhorst*, 263 N.Y. 148, 188 N.E. 285 (1933); *Contra*, *Peritz v. Taub*, 279 Ill. App. 264 (1935).

<sup>14</sup> 26 A.L.R. 33 (1923).

2. If such a lease contains an option to purchase the property, the option must be subordinated to the mortgage. Otherwise there is danger that exercise of the option would extinguish the mortgage.

3. Complete subordination of a prior lease to a subsequent mortgage is legally possible. A subordination agreement signed by the lessee makes his lease junior to the mortgage, subject to extinguishment by foreclosure of the mortgage, just as if the lease had been signed after the recording of the mortgage. Oddly enough subordination of the lease to the mortgage in some respects weakens the mortgagee's position, as is evident from the subsequent discussion.

4. In title and intermediate states, on default in the mortgage payments, the mortgagee has the right to serve a demand on a senior lessee (one whose lease antedates the mortgage) and the lessee must thereafter pay rent to the mortgagee. The lessee has no right to move out, as is true of junior lessees, as hereinafter explained. This rule stems from the notion in title and intermediate states that the mortgage is a transfer of some sort of title to the mortgagee, a notion previously referred to herein. Because of this mysterious transfer of title, there is created between the lessee and the subsequent mortgagee an equally mysterious link called "privity of estate." It is this privity of estate that makes the lessee liable to a subsequent mortgagee for rents.<sup>15</sup> While it has its benefits, this rule also carries some burdens as we shall subsequently see. This rule, it is evident, has one unusual consequence, namely, it helps the mortgagee collect rent where his mortgage is junior to the lease. Naturally, the tenant has no obligation to pay rent to such mortgagee until the mortgagee serves a demand on the tenant to pay such rent.<sup>16</sup>

In lien theory states, the mortgagee ordinarily is not entitled to make such a demand on the tenant.<sup>17</sup> This follows from the fact that in these states a mortgage conveys no title; hence privity of estate is lacking.

#### LEASES JUNIOR TO THE MORTGAGE

With respect to leases that are junior to the mortgage (e.g., leases made by the mortgagor after the recording of the mortgage) the following rules are applicable:

<sup>15</sup> OSBORNE, MORTGAGES 347 (1951); 55 L.R.A. (n.s.) 190, 200 (1915).

<sup>16</sup> OSBORNE, MORTGAGES 347 (1951).

<sup>17</sup> 55 L.R.A. (n.s.) 190, 200 (1915).

1. Such a lease can be extinguished by foreclosure of the mortgage.
2. Occasionally a mortgagee will wish to foreclose his mortgage without extinguishing the lease. In some states this is possible and in others not.<sup>18</sup> In states where it is legally impossible to preserve a junior lease when a mortgage is foreclosed, a mortgagee must be wary of placing reliance on such leases.
3. In title and intermediate states the mortgagor has the right to evict junior leases as soon as default occurs in the mortgage payments. This is also true in lien states where a clause is inserted in the mortgage giving the mortgagee the right to possession on default and the state is one that recognizes the validity of such a provision. Alternatively the mortgagee may serve a demand which gives the tenant a choice as between moving out or paying rent to the mortgagee. However, the mortgagee cannot compel the tenant to remain and pay rent to him. This is so because where the lease is subsequent to the mortgage, there is no privity of estate between the mortgagee and the lessee.<sup>19</sup> For this reason, it is better for the mortgagee to proceed in such a situation under the assignment of rents, for then the tenant must stay and pay rent to the mortgagee.<sup>20</sup>
4. If the mortgagee enters under his mortgage, as stated in paragraph three, and the tenant chooses to remain and pay rent, in many states the result is to terminate the lease and create a month-to-month or year-to-year tenancy.<sup>21</sup> Here again if the mortgagee wishes to preserve the leases it is best for him to proceed under his assignment of rents rather than under the mortgage.

#### ASSIGNMENT OF RENTS

At the time the mortgage is signed, the mortgagee should require the mortgagor to sign a *separate* assignment of leases and rents. This document assigns to the mortgagee all existing leases, all leases to be executed in the future, and all rents falling due after the date of the mortgage, all as additional security for payment of the mortgage debt. Lawyers have found that there is magic in the argument that the mortgage creates a lien on the land, and that the assignment creates a lien on the rents.<sup>22</sup> All existing tenants are notified of the mak-

<sup>18</sup> 109 A.L.R. 455 (1937).

<sup>19</sup> OSBORNE, MORTGAGES 350 (1951).

<sup>20</sup> Chicago City Bank & Trust Co. v. Walgreen Co., 272 Ill. App. 434 (1933).

<sup>21</sup> OSBORNE, MORTGAGES 352 (1951).

<sup>22</sup> OSBORNE, MORTGAGES 371-72 (1951).

ing of the assignment. The assignment is recorded. The following rules are applicable:

1. In most lien states an assignment of rents enables the mortgagee to reach the rents accruing prior to foreclosure sale and treat them as part of the security for his debt. This gives the mortgagee in a lien state virtually as favorable a position with regard to rents as the mortgagee has in title and intermediate states. In one or two lien states an assignment of rents, like the mortgage clause giving the right to take possession on default, is held invalid as being opposed to public policy.<sup>23</sup> Also in a few lien states an assignment signed contemporaneously with the mortgage is given only limited recognition. In these states after a default occurs, and after the assignment has been activated as hereinafter discussed, rents collected by the mortgagee can be applied only to maintain the property or to pay taxes or insurance. They cannot be applied in reduction of the mortgage debt.<sup>24</sup>

2. Since the assignment does not contemplate that the mortgagee will begin collecting rents immediately upon the signing of the assignment, but only after a default occurs, the assignment is inoperative until it is "activated" by some action of the mortgagee.<sup>25</sup> Rents collected by the mortgagor before the assignment is activated belong to the mortgagor,<sup>26</sup> or they may become the property of a junior mortgagee who exercises greater diligence. If *A* holds a first mortgage and *B* holds a second mortgage on the same property, default occurs, and *B* activates his assignment but *A* does not, *B* gets the rents.<sup>27</sup> Even specific language that the assignment will operate automatically on default has been held insufficient to activate the assignment.<sup>28</sup> There are a number of cases which contain the statement that an assignment can be drafted to operate automatically, and one or two cases appear to so hold.<sup>29</sup> A number of cases stating this rule are cited in *Kinnison v. Guaranty Liquidating Corp.*,<sup>30</sup> but as you

<sup>23</sup> Hart v. Bingman, 171 Okla. 429, 43 P.2d 447 (1935).

<sup>24</sup> Mutual Benefit Life Ins. Co. v. Canby, 190 Minn. 144, 251 N.W. 129 (1933); Western Loan & Bldg. Co. v. Mufflin, 162 Wash. 33, 297 Pac. 743 (1931).

<sup>25</sup> Mortgage Guar. Co. v. Sampsell, 51 Cal. App. 2d 180, 124 P.2d 353 (1942); In re Clark Realty Co., 234 Fed. 576 (1916).

<sup>26</sup> Sullivan v. Rosson, 223 N.Y. 217, 119 N.E. 405 (1918); Note, *The Mortgagee's Right to Rents After Default*, 50 YALE L.J. 1424 (1941).

<sup>27</sup> Stevens v. Blue, 388 Ill. 92, 57 N.E. 2d 451 (1944).

<sup>28</sup> Dime Sav. Bank of Brooklyn v. Lubart, 38 N.Y.S. 2d 252 (1942).

<sup>29</sup> New Jersey Nat'l Bank & Trust Co. v. Wolf, 108 N.J. Eq. 412, 155 Atl. 372 (1931).

<sup>30</sup> 18 Cal. 2d 256, 115 P.2d 450 (1941).

read these cases almost invariably there is some circumstance present which reveals some demand, suit for rent, voluntary payment of rent by mortgagor or other action taken by the mortgagee to activate the assignment. It must be deemed unsafe, as a business proposition, to rely on any automatic operation of the assignment. Michigan has a statute which may create a special situation in that state.<sup>31</sup>

3. Everywhere the assignment is properly activated if the mortgagor consents to collection of the rent after default and pursuant to the assignment, and the tenants begin paying rent to the mortgagee.<sup>32</sup>

4. In title and intermediate states the assignment is activated on default by the mortgagee's serving notice on the tenants to pay rent to the mortgagee. The mortgagor's consent is unnecessary.<sup>33</sup>

5. In some lien states the assignment can be activated in the same manner as in title states.<sup>34</sup>

6. In other lien states the assignment can be activated only by the mortgagee's filing a foreclosure suit and applying for the appointment of a receiver.<sup>35</sup> Of course these same steps will serve to activate an assignment in a title or intermediate state.<sup>36</sup>

7. In one or two lien states an assignment can only be activated by the mortgagor voluntarily turning over possession to the mortgagee or allowing the mortgagee to collect rents.<sup>37</sup>

8. Rents collected by the mortgagee under an activated assignment must be applied to taxes, repairs, insurance and, in most states, the mortgage debt.

9. Whenever a mortgagee acts under an activated assignment, he does not destroy existing leases, as sometimes occurs when a mortgagee takes possession under his mortgage. An assignment preserves valuable leases.

10. A mortgagee acting under an assignment is accountable to the mortgagor only for rents actually collected.

<sup>31</sup> *Security Trust Co. v. Sloman*, 252 Mich. 266, 233 N.W. 216 (1930); *Smith v. Mutual Ben. Life Ins. Co.*, 362 Mich. 114, 106 N.W. 2d 515 (1960).

<sup>32</sup> 50 Yale L.J. 1424 (1941), *supra* note 26.

<sup>33</sup> *Randal v. Jersey Mortgage Inv. Co.*, 306 Pa. 1, 158 Atl. 865 (1932); *Grannis-Blair Audit Co. v. Maddux*, 167 Tenn. 297, 69 S.W. 2d 238 (1934); 2 JONES, MORTGAGES 366 (8th ed. 1928).

<sup>34</sup> *Kinnison v. Guaranty Liquidating Corp.*, 18 Cal. 2d 256, 115 P.2d 450 (1941); *Long Island Bond & Mortgage Guar. Co. v. Brown*, 11 N.Y.S. 2d 793 (1939).

<sup>35</sup> *Dick & Reuteman Co. v. Jem Realty Co.*, 225 Wis. 428, 274 N.W. 416 (1937); *Hall v. Goldsworthy*, 136 Kan. 247, 14 P.2d 659 (1932).

<sup>36</sup> *Fleischer v. Flick*, 334 Ill. App. 461, 80 N.E. 2d 81 (1948).

<sup>37</sup> *Hart v. Bingman*, 171 Okla. 429, 43 P.2d 447 (1935).

11. When a mortgagee who holds an assignment of rents sells and assigns his mortgage, he should also assign the assignment of rents to the assignee of the mortgage.<sup>38</sup>

RENT REDUCTIONS, LEASE CANCELLATIONS AND  
ADVANCE PAYMENTS OF RENT

A problem of considerable importance is the extent to which a receiver or a mortgagee entering into possession is bound by rent reductions, prepayments of rents, and lease cancellations effected by the mortgagor for a cash consideration. Such agreements are standard devices by which hard-pressed mortgagors pocket the future earning capacity of the land and deliver to the mortgagee the empty shell of the mortgaged asset. Again, differences exist between title theory and lien theory states. The following are some of the applicable rules:

1. In title and intermediate theory states, when the lease is made subsequently to the mortgage, the mortgagee is not bound by any advance rent payments made by the tenant to the mortgagor, and on appointment of a receiver or on the mortgagee's taking possession of the land, the tenant will nevertheless have to pay rent thereafter to such receiver or mortgagee, even though he has already paid his rent in advance to the mortgagor.<sup>39</sup> This rule follows from the rule that recording of the mortgage gives all the world, including subsequent tenants, notice of the mortgagee's rights, and these rights include the right to take possession on default. This rule is of special importance to a tenant who pays a large sum of money for the privilege of receiving a lease, for example, a tenant in a co-operative apartment; a tenant of commercial space who pays a large "bonus" for receiving his lease; or any tenant who plans to make substantial investments in alterations in reliance on his lease.

2. In title and intermediate states, if the lease antedates the mortgage, recording of the mortgage does not give the tenant notice of the mortgagee's rights, for recording of the mortgage gives notice only to those persons who acquire rights in the property *after* recording of the document. The question therefore arises, if the tenant, acting in good faith and in ignorance of the mortgage, prepays his rent to the mortgagor, and the mortgagor thereafter defaults, is

<sup>38</sup> Koury v. Sood, 74 R.I. 486, 62 A. 2d 649 (1948).

<sup>39</sup> Rohrer v. Deatherage, 336 Ill. 450, 168 N.E. 266 (1929).

this prepayment binding on the mortgagee, or must the tenant pay his rent again to the mortgagee? Some cases hold for the mortgagee and some hold for the tenant.<sup>40</sup> The mortgagee can protect himself by procuring, at the time the mortgage is signed, an assignment of all existing leases, and by giving tenants notice at that time of his rights under such assignment.

3. In many lien theory states, the mortgagee is bound by advance payments of rents made in good faith by the tenant to the mortgagor, and when the mortgagee's receiver takes possession he will find himself unable to collect any rents from the tenant.<sup>41</sup>

4. But even in lien theory states following the rule stated in the last preceding paragraph, if the mortgagee, at the time the mortgage is made, obtains from the mortgagor an assignment of rents and leases and notifies the tenants thereof as suggested in the discussion of rent assignments, the mortgagee will not be bound by any advance payments of rent made by the tenant to the mortgagor.<sup>42</sup> Also no rent reduction granted by the mortgagor after the tenant has notice of this assignment will be effective.<sup>43</sup>

5. Where the mortgagor, at the time of making the mortgage, by a separate instrument, assigns an existing lease to the mortgagee, and the lessee is notified of the assignment, the tenant and mortgagor thereafter cannot cancel the lease, or reduce the rent, so far as the mortgagee is concerned. On the mortgagee's taking possession, or on the appointment of a receiver, the tenant can be held to his lease.<sup>44</sup> If there is no assignment of rents, and the lease is prior to the mortgage, a cancellation of the lease made by the mortgagor and lessee may be valid.<sup>45</sup>

<sup>40</sup> ANNOT., 1916 D ANN. CAS. 200; 55 L.R.A. (N.S.) 233 (1915); 2 JONES, MORTGAGES 362 (8th ed. 1928).

<sup>41</sup> Smith v. Cushatt, 199 Ia. 690, 202 N.W. 548 (1925); Ottman v. Tilbury, 204 Wis. 56, 234 N.W. 325 (1931); Isaacs v. Greenberg, 145 N.Y.S. 921 (1914); Fidelity Union Trust Co. v. 75 Prospect Co-op Apt., 131 N.J. Eq. 387, 25 A. 2d 508 (1931).

<sup>42</sup> Cloter Realty Inc. v. Primer Realty Corp., 27 N.Y.S. 2d 850 (1941); Bank of Manhattan Trust Co. v. 571 Park Ave. Corp., 263 N.Y. 57, 188 N.E. 156 (1933); Franzen v. G. R. Kinney Co., 218 Wis. 53, 259 N.W. 850 (1935).

<sup>43</sup> Franzen v. G. R. Kinney Co., 218 Wis. 53, 259 N.W. 850 (1935).

<sup>44</sup> Metropolitan Life Ins. Co. v. W. T. Grant Co., 321 Ill. App. 487, 53 N.E. 2d 255 (1944); Mercantile & Theaters Properties v. Stanley Co., 346 Pa. 343, 30 A. 2d 136 (1943); Franzen v. G. R. Kinney Co., 218 Wis. 53, 259 N.W. 850 (1935); Darling Shop v. Nelson Realty Co., 262 Ala. 495, 79 So. 2d 793 (1955).

<sup>45</sup> Metropolitan Life Ins. Co. v. W. T. Grant Co., 321 Ill. App. 487, 53 N.E. 2d 255 (1944).

With respect to the language of the assignment, some suggestions might be pertinent:

1. It should be a document separate from the mortgage. It should assign the mortgagor's interest in all existing leases and the interest of the mortgagor, or his assignee, in leases that may be executed in the future by the mortgagor, or his assignees. Leases of any importance should be specifically set forth in the assignment.

2. It might be helpful not to state that the assignment will only become operative on default, but instead make the assignment a presently operative assignment, giving the mortgagor the privilege of collecting and keeping rent until default. Include a clause reading as follows:

Notwithstanding that this instrument is a present assignment of said rents it is understood and agreed that the undersigned may collect the same and manage said real estate and improvements the same as if this assignment has not been given, if and so long as only the undersigned shall not be in any default whatever with respect to the payments of principal and/or interest due on said loan, or in the performance of any other obligation on our part to be performed thereunder.

3. The mortgage should refer to the assignment of rents and the assignment of rents should refer to the mortgage, so that the mortgagee can resort to one or the other as convenience dictates, and should permit entry under mortgage as to part of the premises and under assignment as to other parts of the premises.

*Example:* As to one store in the building a lease junior to the mortgage is so unfavorable that it should be terminated and the tenant ousted. Enter under the mortgage.

*Example:* As to another store a lease junior to the mortgage is very favorable. Enter under the assignment.

4. The right to cancel or alter existing leases should be included.

5. The assignment should include the right to the use and possession of furniture, appliances, etc. While such a provision will be helpful, neither a rent assignment nor the appointment of a receiver is a substitute for a chattel mortgage. In other words, if there is valuable personal property on the mortgaged premises (e.g., a hotel) the mortgagee may not have the legal right to the possession of such personal property unless he has a chattel mortgage.<sup>46</sup>

6. The assignment should include the right to operate the business (hotels, etc.) and to take possession of books and records.

<sup>46</sup> 44 YALE L. J. 701 (1935).



7. The assignment should confer the right to apply rents to the payments on furniture bought on credit, to insurance premiums on personal property, etc.

8. The assignee should be given the right to apply rents to the mortgage debt. Otherwise some states limit application of rents collected to taxes and maintenance.<sup>47</sup>

9. The document should provide that the assignee shall not be accountable for more monies than it actually receives from the mortgaged premises, nor shall it be liable for failure to collect rents.

10. The document should forbid any cancellation or modification of leases and should also forbid any prepayment of rent except the normal prepayment of monthly rent on the first of the month.

11. Authority should be given the assignee to sign the name of the mortgagor on all papers and documents in connection with the operation and management of the premises.

12. The assignment should provide that any assignee of the assignment shall have all the powers of the original assignee.

13. It should contain a recital that:

(A). All rents due to date have been collected and that no concessions have been granted.

(B). No rents have been collected in advance.

14. It should provide that the assignee may execute new leases, including leases that extend beyond the redemption period.

Of course, neither an assignment of rents nor any other device can make a good lease out of a bad one.

*Example:* A shopping center lease to a department store provides that if five per cent or more of the parking lot is condemned, the tenant may terminate the lease. This is a key lease, providing revenue for retirement of the mortgage. It must be amended because if five per cent or more of the parking lot is condemned (for example, for a street widening) and the tenant terminates the lease, the mortgage will go into default.

If the lease provides for a security deposit by the tenant with the landlord, an assignment of leases and rents standing alone, gives the mortgagee no right to the security deposit.<sup>48</sup> Specific language should be included in the assignment transferring all rights in the security deposit.

<sup>47</sup> *Western Loan & Bldg. Co. v. Mufflin*, 162 Wash. 33, 297 Pac. 743 (1931).

<sup>48</sup> *Anuzis v. Gotowtt*, 248 Ill. App. 536 (1928); *Keusch v. Morrison*, 240 App. Div. 112, 269 N.Y.S. 169 (1934); 52 C.J.S. *Landlord & Tenant* § 473 (1947).

If the mortgagee receives an assignment of the security deposit and the securities or money are handed over to the mortgagee:

- (A). In New York and some other states the mortgagee must not commingle the security deposit with his own money. It is a trust fund. Commingling will instantly make the mortgagee liable to the tenant for wrongful misappropriation of the fund.<sup>49</sup> In other states commingling is allowed.
- (B). In New York and some other states, the mortgagor-landlord does not relieve himself of liability for the securities by depositing them with the mortgagee. He cannot in this fashion rid himself of the trust. The mortgagor should therefore insist on the tenant's consent to such transfer.

#### STATUTORY REDEMPTION

Any discussion of the mortgagee's right to possession and rents would be incomplete without mention of the statutory right of redemption. When a mortgage foreclosure sale is held, the equitable right of redemption ends. Indeed, the whole object of the foreclosure suit is to put an end to the mortgagor's equitable right of redemption. In the last hundred years, however, laws have been enacted giving the mortgagor an additional concession. Under these laws, the mortgagor is given one last chance to get his property back. Suppose, for example, that a farmer whose farm is mortgaged has a bad crop year. He cannot meet his mortgage payments and the mortgage is foreclosed. Perhaps next year crops will be good, and he will have enough to pay all of his debts. To afford farmers and other mortgagors one last opportunity to salvage their properties, legislatures have passed laws allowing additional time, often one year, after the foreclosure sale, during which the mortgagor can, by paying the amount of the foreclosure sale price, get his property back from the mortgagee. This right is called the statutory right of redemption. Thus, the equitable right of redemption ends with the holding of the foreclosure sale, and the statutory right of redemption begins at that time.

Laws providing for statutory redemption have not been passed in all states. California, Connecticut, Delaware, District of Columbia, Georgia, Idaho, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Ohio, Penn-

<sup>49</sup> *Mallory Associates Inc. v. Barving Realty Co.*, 300 N.Y. 297, 90 N.E. 2d 468 (1949); *2300 Concourse Realty Corp. v. Klug*, 111 N.Y.S. 2d 168 (1952).

sylvania, Rhode Island, South Carolina, Tennessee, Texas, Virginia and West Virginia apparently do not have redemption laws. Laws in Florida, Indiana, Nebraska, Oklahoma and Wisconsin provide for a postponement of the foreclosure sale, which is not a true redemption law. Special and unusual laws exist in Arkansas, Kentucky, Missouri and New Jersey.<sup>50</sup> In states that have true redemption laws, the redemption period follows the foreclosure sale. In states where redemption laws have been passed, a modification of foreclosure procedure has resulted. For example, in states having redemption laws, the purchaser at the foreclosure sale usually does not immediately receive a deed to the property; instead he receives only a certificate stating that he will be entitled to a deed if redemption is not made. The rules regarding the mortgagee's right to possession and rents during the statutory redemption period differ from state to state.

#### RESTRICTIVE COVENANTS

If there are any recorded restrictive covenants binding the premises, a mortgagee who takes possession whether by virtue of his mortgage, an assignment of rents, or through foreclosure of the mortgage will naturally be enjoined from violating the restrictions, for in equity all those who have notice of restrictions are bound by them.<sup>51</sup>

#### COVENANT LIABILITY

Suppose a lease contains some covenant that places a heavy burden on the landlord, such as a covenant on the part of the landlord to rebuild buildings on the leased premises in the event of their destruction by fire or other casualty. If the leased property is thereafter mortgaged, and the mortgage is later foreclosed, subject, of course, to the lease, and the lease survives the foreclosure, and after the mortgagee has become the owner of the property by foreclosure there is a failure to rebuild, the mortgagee in all states would be liable. He has taken over all the privileges and burdens of being a landlord.<sup>52</sup> Questions arise, however, as to the mortgagee's liability arising *before* foreclosure has been completed. Unfortunately the cases on these questions are so meager that few conclusions can safely be drawn.

However, since conclusions must be drawn, the first conclusion

<sup>50</sup> Prather, *Foreclosure of the Security Interest*, 1957 U. ILL. L.F. 420, 450.

<sup>51</sup> KRATOVIL, *REAL ESTATE LAW* 387 (3rd ed. 1958).

<sup>52</sup> 51 C.J.S. *Landlord & Tenant* § 368 (1947).

one may draw is that mortgagees probably have little to fear from this source. An intensive study of the law reveals virtually no litigation on this question. Inquiry among mortgagees reveals no loss experience. Perhaps this is due to the fact that mortgagees are pretty careful about getting involved in situations where they might ultimately, by foreclosure, be saddled with burdensome leases. Another explanation may lie in the fact that leases being for the most part drafted by landlords place few oppressive burdens on the landlord. As between landlord and tenant, the greater bargaining power often lies with the landlord, although shopping center leases, particularly chain-store leases and department store leases, may provide an exception. For the most part, also, mortgagees are careful to provide themselves with insurance against loss in such cases.

#### COVENANT LIABILITY IN TITLE AND INTERMEDIATE STATES

When we turn away from practical business aspects of the problem to technical legal aspects, we are again compelled to speculate because of the dearth of authority on the problem. In the situation where a mortgage follows a lease we found that in title and intermediate states the mortgagee can compel the tenant to pay rent to him when default in the mortgage payments occurs because in title and intermediate states there is, in this situation, this mysterious privity of estate between the mortgagee and the lessee. Privity of estate carries with it burdens as well as benefits. Whenever the mortgagee is allowed to step into the landlord's shoes for the purpose of reaping benefits as against the lessee he must also stand in the landlord's shoes for the purpose of carrying some of the landlord's liabilities. It would therefore appear to follow that in title and intermediate states, where the lease antedates the mortgage, there is danger that the mortgagee will be held liable to the tenant for breach of any lease covenants that "run with the land." Much has been written to illuminate the problem of what covenants may be said to run with the land.<sup>53</sup> For our present purposes it is enough to say that some covenants run and others do not. A covenant to rebuild a building would very likely run with the land.

We can test out the validity of these conjectures by turning to the

<sup>53</sup> Clark, *REAL COVENANTS AND OTHER INTERESTS THAT RUN WITH THE LAND*, *passim* (2nd ed. 1947); Williams, *Restrictions on the Use of Land: Covenants Running with the Land at Law*, 27 TEXAS L. REV. 419 (1949).

situation where a leasehold estate is mortgaged. In title and intermediate states a mortgage of the leasehold creates privity of estate. In other words, a mortgagee of the leasehold in such states stands in the tenant's shoes and has virtually all the benefits and burdens that attach to the tenant's status. In some of these states (notably Maryland, New Hampshire and Virginia), the courts have held flatly that because of this privity of estate the mortgagee of a leasehold is liable for rent under the lease if the tenant fails to pay it.<sup>54</sup> This tends to support the conjecture that in title and intermediate states the mortgagee would be liable on our hypothetical covenant to rebuild. In some states, however, and this includes some title, intermediate and lien states the courts have refused to hold the mortgagee liable for rent unless he takes possession of the property.<sup>55</sup>

It will thus be seen that strict legal reasoning cannot lead us to a definite conclusion on the problem of covenant liability. All one can say is that the possibility of liability is present in title and intermediate states where the lease antedates the mortgage.

Of course where the mortgage antedates the lease we have said that the mortgagee cannot compel the tenant to remain in possession and pay rent, since privity of estate is lacking. This lack of privity of estate should insulate the mortgagee from covenant liability, prior to completion of his mortgage foreclosure.

#### COVENANT LIABILITY IN LIEN STATES

In a lien jurisdiction, a mortgage is not regarded as transferring any title whatever. One could speculate, in consequence, that where a lease antedates a mortgage in a lien state, the mortgage will not create any privity of estate and therefore the mortgagee will have no liability on the landlord's covenants contained in the lease. This conclusion finds support in the rule, heretofore expressed, that in a lien state, absent any valid assignment of rents or any valid provision in the mortgage conferring on the mortgagee the right to possession or rents, rents are not a part of the mortgage security. Rents belong to the title holder and the mortgagee has no title. Since the mortgagee enjoys no benefits under the lease it is arguable that he should not be saddled with burdens. Unfortunately this solution, while logical, may not be universally accepted by the courts. Turning to the analogy of

<sup>54</sup> 73 A.L.R. 2d 1118, 1121 (1960).

<sup>55</sup> 73 A.L.R. 2d 1118, 1125 (1960).

the mortgage on a leasehold, we find that in New York, a lien state, if the mortgagee of a leasehold takes possession of the premises this establishes privity of estate between the mortgagee and the landlord, which results in the creation of liability on the part of the mortgagee on those covenants that run with the land.<sup>56</sup> The New York rule, however, appears to be without merit and it is unlikely that it will command much support elsewhere for the trend in lien and intermediate states is to hold the mortgagee of leasehold not liable for payment of rent or breach of the lease covenants until foreclosure of the mortgage has been completed and the mortgage has acquired the leasehold estate.<sup>57</sup> Of course, where the mortgage antedates the lease, in lien states as in title states there is a total absence of privity of estate; hence the mortgagee cannot be held liable on any covenants running with the land prior to the completion of the foreclosure. With the completion of the foreclosure, ownership of the land passes to the mortgagee, assuming he is the successful bidder at the foreclosure sale, and with this ownership liability on lease covenants will attach, since privity of estate will then be present.

#### COVENANT LIABILITY UNDER AN ASSIGNMENT OF RENTS

Suppose that in a title or intermediate state *A* leases to *B*. Thereafter *A* mortgages to *C* and assigns the lease to *C*. When default occurs under the mortgage, *C* chooses to collect rent *not under the mortgage but under the assignment*. There is authority for the view that such an assignment is not a transfer of the reversion, and *C* is entitled to rents without the creation of the privity of estate on which liability depends.<sup>58</sup> If this is true, it should follow that *C* would not be liable to the tenant for breach of the lease covenants.<sup>59</sup> It cannot be stated flatly that this solution will command universal acceptance. Courts might understandably be reluctant to allow *C* the benefits un-

<sup>56</sup> *Astor v. Hoyt*, 5 Wend. 603 (N.Y. 1830); 73 A.L.R. 2d 1118, 1129 (1960).

<sup>57</sup> *Feldman v. Urban Commercial Inc.*, 64 N.J. Super. 364, 165 A. 2d 854 (1960); *Amco Trust Inc. v. P. C. Naylor*, 159 Tex. 146, 317 S.W. 2d 47 (1960); 73 A.L.R. 2d 1118, 1131 (1960); Indeed the law of covenants in general has had an unhappy history in New York. 35 N.Y. U. L. Rev. 1344, 1356 (1960).

<sup>58</sup> *Orman v. Burgess*, 217 Ill. App. 311 (1920); *Winnisimmet Trust Inc. v. Libby*, 232 Mass. 491, 122 N.E. 575 (1919); 55 L.R.A. (n.s.) 196 (1915); 51 C.J.S. *Landlord & Tenant* §§ 259, 260, 368 (1947).

<sup>59</sup> *S. H. Cohn Co. v. Simon*, 17 Ohio C.C.R. (n.s.) 371 (1916); *McDougall v. Ridout*, 9 V.C.Q.B. 239.

der the lease without bearing the burdens.<sup>60</sup> There appear to be few court decisions on this point.

It is possible that the answer to this question may rest in part on the form of the assignment. If the assignment purports to be an assignment of the *lease* as well as an assignment of the *rents*, it is arguable that an assignment in this form creates some sort of privity of estate and liability would therefore ensue on covenants that run with the land. Again, we need to remind ourselves that an assignment by the lessor of the lease is an ambiguous document. A lessor who wishes to transfer his title or reversion would use a deed. A lessor who wishes to keep his title or reversion while conveying the right to receive rent, would use an assignment of rents for that purpose. A conveyance of the title or reversion would create privity of estate; an assignment of rents would not. An assignment by the lessor of the lease and rents thereunder falls somewhere between a conveyance of the title and an assignment of the rents. It has been speculated as follows:

When the lessor has actually assigned his lease or his interest under the lease, with no indication as to what was intended to pass, the most reasonable rule is, and most courts have held, that unaccrued rents pass, together with such covenants as are designed for the collection thereof, but all covenants designed for the protection of the reversion, with the reversion itself, remain in the assignor.<sup>61</sup>

For this reason, some mortgagees deliberately omit any assignment of the lease in the assignment of rents form. They argue that, while an assignment of the lease is automatically an assignment of rents accruing thereunder, an assignment of rents is not automatically an assignment of the lease and the covenants therein. As against this, one must weigh the fact that it is the assignment of the lease to the mortgagee that appears significant to the courts in protecting the mortgagee against lease cancellations and advance payment of rents to the mortgagor. The latter is an actual danger, as experience reveals. The danger of covenant liability seems remote. Moreover, a lease is a contract as well as a conveyance. The stipulations therein contained are promises as well as covenants. The assignment of the benefits of a contract does not present the technical problems, like those concerning privity of estate, inherent in the law of covenants running with the land. It is this reasoning that prompts a purchaser of land to demand that the seller give him an assignment of existing leases. An as-

<sup>60</sup> *Cargill v. Thompson*, 57 Minn. 534, 59 N.W. 638, 642 (dissenting opinion) (1894).

<sup>61</sup> 55 L.R.A. (n.s.) 196 (1915).

signment of the lease would carry the contract rights or choses in action of the landlord even though privity of estate is wholly lacking.<sup>62</sup> It is doubtful that an assignment of rents would have this effect.

In lien states the danger of covenant liability, even where the mortgage is accompanied by an assignment of leases and rents, should always be less when in a title or intermediate state. There is less likelihood that a court might find privity of estate to be present.

#### OCCUPIER LIABILITY

A mortgagee who proceeds to collect rents after the mortgagor's default becomes personally liable for injuries caused by defects in the premises:

1. If the acts of the mortgagee amount to a taking of possession.
2. And if an owner in possession would be liable under the same circumstances.

*Example:* A tenant, or a member of his family, or a delivery boy, or other person lawfully on the premises is injured on a common stairway that has fallen into disrepair owing to the negligence of the mortgagor or the mortgagee.

*Example:* The building, when the mortgagee assumes control, is (or later becomes) dangerous to the public traveling along adjoining sidewalks or streets, as where the building coal hole in the sidewalk has a defective cover, and a pedestrian falls as a result and is injured.<sup>63</sup> This type of liability is such that even if the mortgagee leases the entire building to a lessee in an effort to rid himself of the control of the dangerous structure, the mortgagee's liability will nevertheless continue thereafter. One who "leases a nuisance" to a tenant is liable for subsequent injuries.

*Example:* The mortgagee, or his building manager, or his other

<sup>62</sup> Occasionally one hears it said that a deed of leased property gives the grantee all the contractual rights ("privity of contract") the lessor enjoyed as against the grantee. 55 L.R.A. (n.s.) 190, 211 (1915). This is supposed to be by virtue of an Act of Parliament passed during the reign of Henry VIII *ibid*. This is open to question. It is more likely that this venerable law was addressed to King Henry's special problems with confiscated church lands, and did not concern itself with transfer of contractual rights. 2 POWELL, REAL PROPERTY 315 (1950); 1 TIFFANY, LANDLORD & TENANT 833 (1910). American laws patterned after this Act of Parliament present the same problem. Because of this doubt a buyer of leased land will often insist that the seller give the buyer an assignment of the seller's rights under the leases. If a buyer needs this protection, it is obvious that a mortgagee has even greater need for the protection, for his rights are never as comprehensive as those of a buyer.

<sup>63</sup> *Ferman v. Lombard Inv. Co.*, 56 Minn. 166, 57 N.W. 309 (1894).



agents learn of a dangerous but not obvious condition in an apartment and fail to warn an incoming tenant, who is injured as a result, as where there is a defective floor in a dark closet.

Other illustrations of this "occupier liability" could be furnished. It is obvious that these liabilities impose a continuing obligation to inspect. For example, even if a lease is made to a tenant at a time when the premises are safe, an inspection must be made before a new lease is made, even to the same tenant, for if the premises have become dangerous in the meanwhile, the mortgagee-landlord will be liable on the theory that he made a lease (the new lease) of defective premises for a use that contemplated invitation of the public to the premises.<sup>64</sup>

Suppose that the mortgagee merely collects rents, leaving actual control of the building in the mortgagor. Here the mortgagee has no *occupier liability*.<sup>65</sup> This situation is a rarity. As a rule, if a mortgagee steps in, he wants to control the building, the new leases, maintenance, insurance, and the like, and if he exercises such control the mortgagee has occupier liability even though he purports to be acting under an assignment of rents.<sup>66</sup>

#### RECENT ILLINOIS LEGISLATION CONCERNING MORTGAGEE'S RIGHT TO POSSESSION

It is a matter of common knowledge, in Illinois, that a mortgagee has the right to take possession of the mortgaged premises on default, except as against a lessee under a lease senior in right to the mortgage. However there has never been a completely practical remedy to enforce this well-recognized right. To remedy this long-neglected oversight, House Bill 295 was enacted, effective August 7, 1961.

Procedurewise, the Act provides that upon the application by the mortgagee and reasonable notice to the owners of the premises (whether or not service of process has been effected) the court may enter an order placing the mortgagee in possession, but if the premises are occupied by the owner or a contract purchaser as a residence or homestead, such order cannot be entered until the owner has been served with summons or by publication. If the right of the mortgagee to take possession is controverted under oath, a hearing is conducted,

<sup>64</sup> KRATOVIL, *REAL ESTATE LAW* 453 (3rd ed. 1958).

<sup>65</sup> *Luther P. Stephens Inv. Co. v. Berry Schools*, 188 Ga. 132, 3 S.E. 2d 68 (1939).

<sup>66</sup> *Scott v. Hoboken Bank*, 126 N.J.L. 294, 19 A. 2d 327 (1941); *Zisman v. City of Duquesne*, 143 Pa. Super 263, 18 A. 2d 95 (1941); 41 C. J. *Mortgages* § 580 (1926).

and if the court is satisfied that there is a reasonable probability that the plaintiff will prevail in the action, it may enter an order placing the mortgagee in possession.

The original draft of this bill as it went into the Legislature used the word "shall" throughout, conveying the notion that it would normally be mandatory upon the court to order the mortgagee placed in possession. However, this language was changed in the final version to provide that the court "may" enter the order in question, thereby creating the inference that the court shall exercise a measure of discretion in this regard. This brings up the question whether the court will in actual practice require proof of inadequacy of security, insolvency of the mortgagor, or the like, as is often required where appointment of a receiver is applied for. Some significance must be attributed to this change in language.

If the premises are occupied by the owner as a homestead, the court may permit him to remain in occupancy notwithstanding the order placing the mortgagee in possession. However, *after foreclosure sale* the mortgagor must pay rent to the mortgagee *if there is a deficiency*. It is a matter for conjecture whether mortgagors will point to this language of the statute in seeking to be excused from paying rent *before* a deficiency is revealed. It may be helpful to the mortgagee here to be able to produce an assignment of leases and rents that specifically requires the mortgagor to pay rent at a specified rate immediately on the occurrence of default.

In its order for possession the court may require the mortgagee to give bond. This is an interesting twist. The prior law<sup>67</sup> permitted the court, in lieu of appointing a receiver, to allow the *mortgagor* to stay in possession on giving bond. Now it is the mortgagee who goes into possession, giving bond where the court deems it proper. Interestingly, the old law has not specifically been repealed.

The order placing or refusing to place a mortgagee in possession is appealable.

Once an order has been entered placing a mortgagee in possession, the mortgagee has all the rights of a mortgagee in possession, which rights are pretty well defined in the old case law, and also all the power and authority conferred upon him by the terms of the mortgage or other written instrument.

Under the old law it was pretty well settled that once a foreclosure

<sup>67</sup> ILL. REV. STAT. ch. 22 § 55 (1959).

sale took place the mortgage was extinguished by merger and any right of possession thereby conferred came to an end.<sup>68</sup> This rather technical holding was actually based on the philosophy that the redemption laws were intended to give the mortgagor-farmer another year in possession, to raise crops, and pay off the sale. If the sale resulted in a deficiency, the court might appoint a receiver, but the mortgagee, as such, had no right to possession. This is changed under the new law, which provides that the mortgagee may remain in possession during the redemption period.

The act is broad in its definition of the mortgagee who may be placed in possession by court order, including in its scope the holder of a note secured by a trust deed, and an agent holding an assignment of rents. This dispenses with the old notion that only the mortgagee having a mortgagee's security title has the right to possession on default.

Under this new law, it should be much easier for the mortgagee, armed with the court order, to induce tenants to pay rent to him. An assignment of rents unsupported by a court order lacks the persuasive force of a court order.

The new law also offers the advantage of the saving of expense incident to a receivership.

Nothing in the law purports to characterize the remedy thereby created as exclusive. Presumably all the old remedies remain. If the court should refuse to place the mortgagee in possession, presumably he might resort to ejectment or perhaps even forcible entry and detainer.<sup>69</sup>

<sup>68</sup> *Schaeppi v. Batholomae*, 217 Ill. 105, 75 N.E. 447 (1905).

<sup>69</sup> *West Side Trust & Sav. Bank v. Lopoten*, 358 Ill. 631, 193 N.E. 462 (1934).